No. 22496

In The

UNITED STATES COURT OF APPEALS

For The Ninth Circuit

MAY [illegible]

GYRO ENGINEERING CORPORATION

Appellant,

vs.

UNITED STATES OF AMERICA

Appellee,

BRIEF FOR THE APPELLANT

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INDEX

CITATIONS

CITATIONS (cont'd)

	Page
STATUTES:	
Internal Revenue Code of 1954:	
Section 351	45, 49
Section 362 (a)	13, 19, 23, 44, 45, 48, 54, 68, 70, 71
Section 368	45
Section 1012	14
Section 1033	71
Section 1239	13, 19, 22, 23, 37, 38, 60
Internal Revenue Code of 1939:	
Section 117 (o)	18, 22
Miscellaneous:	
Accountant's Handbook, 4th Ed. (Wixon)	46
1951 Cum. Bull. July-Dec.	15, 17
H. R. Rep. No. 586, 82nd Cong., 1st Sess.	15, 17
H. R. Rep. No. 1213, 82nd Cong., 1st Sess.	18
3A Mertens, Law of Federal Income Taxation § 21	68
3B Mertens, Law of Federal Income Taxation § 22	15
10 Mertens, Law of Federal Income Taxation, § 58A	48
Sen. Rep. No. 781, 82nd Cong., 1st Sess.	17

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BRIEF FOR THE APPELLANT

OPINION BELOW

The District Court wrote no opinion. Rather it signed and entered the Findings of Fact and Conclusions of Law submitted by the government. (R. 706-753).

JURISDICTION

This is an action arising under the internal revenue laws of the United States. Jurisdiction in the lower court was based on 26 U.S.C.A. § 7422; 28 U.S.C.A. § 1346 (a) (1), 1402 (a) (2). The jurisdiction of this court is based on 28 U.S.C.A. § 1291.

QUESTIONS PRESENTED

Whether the purchase price of $3,194,000 for three (3) parcels of improved real property purchased by appellant on January 1, 1959 constitutes the cost basis in said property?

Whether $30,896.65 received by appellant in 1959 as a condemnation award for real property known as the Paloma Street property is entitled to the nonrecognition of gain provisions in Section 1033 of the 1954 Internal Revenue Code.

STATEMENT

Appellant, Gyro Engineering Corporation, was incorporated in 1952. (R. 59).[1] Among its several corporate purposes, set forth in the corporate charter, were those of manufacturing gyroscopes and purchasing and owning real estate. (R. 59 - 60).[2] Its incorporators and first directors were Chris Mowry, Lee Reynolds and Natalie Mowry (R. 63)[3], the latter being the wife of Chris Mowry. (R. 47).[4] Gyro was founded by the above three incorporators primarily for the purpose of manufacturing gyroscopes and related equipment and to provide limited liability for Chris Mowry. (R. 79).[5] The corporate charter provides that Gyro is authorized to issue only one class of stock, the total number consisting of 10,000 shares having a stated value of

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[1] Exhibit 1 of Stipulation of Facts No. 1, at pp. 1 and 2; Stipulation of Facts No. 1, pgh. 1,p. 2.

[2] Exhibit 1 of Stipulation of Facts No. 1, at pp. 1 and 2.

[3] Exhibit 1 of Stipulation of Facts No. 1, at p. 5.

[4] Stipulation of Facts No. 1, pgh. 4 at p. 2.

[5] Stipulation of Facts No. 2, pgh. 1 at p. 1.

$1.00 per share and an aggregate value of $10,000. (R. 62 - 63).[6]

From the date of incorporation until the middle of April in 1953, Gyro made Scarby test equipment and test panels, but failed to obtain contracts from the Army and Navy for the manufacture of gyroscopes or related equipment. (R. 80 - 81).[7] About the middle of April in 1953, Gyro abandoned its gyroscope and related equipment activities, settled its lease liability for office space it had used for its gyroscope and related equipment activities, and vacated those offices. (R. 80 - 81).[8]

From December 1, 1952 until August 20, 1953, the number of issued and outstanding shares of Gyro's capital stock totaled 5,000 shares of which 4,950 shares were owned by Chris Mowry and 50 shares were owned by Natalie Mowry. (R. 43).[9] On April 20, 1953, 2,500 additional shares were issued to Natalie Mowry, and 2,500 additional shares were issued to Chris Mowry. (R. 48).[10] The 2,500 shares issued to Chris Mowry on April 20, 1953 were transferred to William Mowry (R. 48),[11] Chris Mowry's then 32 year-old brother (R. 89),[12] on April 20, 1953. (R. 48).[13] Chris and Natalie Mowry paid $2,500 for the 2,500 shares issued

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[6] Exhibit 1 of Stipulation of Facts No. 1, at pp. 4 and 5.

[7] Stipulation of Facts No. 2, pgh. 1 at pp. 1 and 2.

[8] Stipulation of Facts No. 2, pgh. 1 at pp. 1 and 2.

[9] Stipulation of Facts No. 1, pgh. 7 at p. 3.

[10] Stipulation of Facts No. 1, pgh. 7 at p. 3.

[11] Stipulation of Facts No. 1, pgh. 7 at p. 3.

[12] Stipulation of Facts No. 2, pgh. 28 at p. 11.

[13] Stipulation of Fact No. 1, pgh. 7 at p. 3.

on April 20, 1953 to Natalie Mowry. (R. 48).[14] Also, $2,500 was paid for the 2,500 shares issued to Chris Mowry on April 20, 1953. (R. 48).[15] William Mowry actually supplied the consideration for a 25 per cent stock interest in Gyro. (R. 49).[16] Thereafter, from April 20, 1953 until November 1, 1958, there were no further changes of stock ownership. (R. 49).

From April 20, 1953 to 1955, Gyro investigated some parcels of real estate. (R. 80).[17] Then on September 21, 1955, Gyro purchased, for investment purposes, at a cost of $7,800 an unimproved parcel of South Pasadena, California, real property, comprised of approximately 70,000 square feet, and known as the Paloma Street property. (R. 49 - 50, 80).[18]

In addition to Gyro's real estate activities for the period subsequent to the middle of April in 1953 until January 1, 1959, Gyro investigated a number of different fields of scientific research including long range weather forecasting, how the eye sees color, and the unified field theory. (Tr. 239 - 240). Each of the above investigations subsequently bore fruit (Tr. 239). Thus Gyro now makes accurate long range weather forecasts, has determined how the eye sees color and has a patent pending covering three dimensional color television, and completed its work on the unified field theory. (Tr. 239 - 240).

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[14] Stipulation of Facts No. 1, pgh. 7 at p. 3.

[15] Stipulation of Facts No. 1, pgh. 7 at p. 3.

[16] Stipulation of Facts No. 1, pgh. 7 at p. 4.

[17] Stipulation of Facts No. 2, pgh. 2 at p. 2.

[18] Stipulation of Facts No. 2, pgh. 2 at p. 2; Stipulation of Facts No. 1, pgh. 8 at pp. 4 and 5.

On or about November 1, 1958, Natalie Mowry surrendered 2,550 shares of Gyro's stock, and on the same day 1,000 shares were issued to Marilyn Mowry, a natural and minor daughter of Chris and Natalie Mowry, 1,000 shares were issued to Patrick Mowry, an adopted and minor son of Chris and Natalie Mowry, and 550 shares were issued to Natalie Mowry. (R. 49;[19] Tr. 41 - 42, 331 - 332). Thereafter, from November 1, 1958 to at least April 29, 1966, the number of issued and outstanding shares of capital stock of Gyro totaled 10,000 shares of which the following number of shares were and are owned by the persons designated below:

Owner	No. of Shares	
Chris Mowry	49.5%	4,950
Natalie Mowry	5.5%	550
Marilyn Mowry	10.0%	1,000
Patrick Mowry	10.0%	1,000
William Mowry	25.0%	2,500
	Total:	10,000

In 1958 Gyro's Paloma Street property was condemned, and Gyro knew some months prior to January 1, 1958, that it would receive approximately $30,000 on about January 1, 1959 as the condemnation award (Tr. 336 - 337).

Thereafter, "on January 1, 1959," Gyro "purchased from Chris and Natalie Mowry three (3) parcels of improved real property known and referred to respectively as (1) 'The Tropics', (2) 'The Carousel', and (3) 'The Orange Grove Circle Apartments'." (R. 50).[20]

The written Sales and Purchase agreement entered into on

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[19] Stipulation of Facts No. 1, pgh. 7 at p. 49 as amended by oral stipulation at trial, Tr. 41-42.

[20] Stipulation of Facts No. 1, pgh. 10 at p. 5.

January 1, 1959 between Gyro, on the one hand, and Chris and Natalie Mowry, on the other hand, provided that the total purchase price of the said three parcels of real property was $3,164,000 (R. 71),[21] that a down payment of $30,000 was required (R. 71),[22] that Gyro assumed trust deed obligations on the three parcels totalling $791,638.50 (R. 86; Tr. 42 - 43),[23] and that Gyro execute and deliver promissory notes totaling $2,342,361.50 payable $60,000 per year in two equal installments of $30,000 each. (R. 71, 86 - 87).[24] The Sales and Purchase Agreement provided that, as further security for the payment of the said $2,342,361.50 in promissory notes, Gyro was to execute and deliver an assignment of rents upon the default in payment of any $30,000 payment. (R. 72). The said promissory notes were delivered by Gyro to Chris and Natalie Mowry (R. 50, 72 - 74).[25] Also, on January 1, 1959, Chris and Natalie Mowry "conveyed by a Grant Deed" the said three (3) parcels of improved real property." (R. 50).[26]

The said purchase price of $3,164,000 was within a reasonable range of the January 1, 1959 fair market value of the said three parcels of improved real property. (Tr. 71, 86, 91, 93; Plaintiff's Exhibit 1).

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[21] Exhibit 4 at p. 1 attached to Stipulation No. 1.

[22] Exhibit 4 at p. 1 attached to Stipulation No. 1.

[23] Stipulation of Facts No. 2, pgh. 16 at lines 26 through 30 at p. 8 as amended by oral stipulation at trial, Tr. 42 - 43.

[24] Stipulation of Facts No. 21, pgh. 16 at lines 30 - 32 at p. 8 and line 1 at p. 9.

[25] Stipulation of Facts No. 1, pgh. 11 at p. 5.

[26] Stipulation of Facts No. 1, pgh. 13 at p. 5.

At the time of the said January 1, 1959 purchase of the three parcels of improved realestate by Gyro, Chris and Natalie Mowry owned 55 per cent of Gyro's outstanding stock, William Mowry, Chris' adult brother, owned 25 per cent of Gyro's outstanding stock, and Chris and Natalie Mowry's two minor children owned 10 per cent each. (R. 49).[27] Since the said three parcels of improved real property were encumbered by trust deeds totalling $791,638.50 whereas the purchase price was $3,164,000, the equity of Chris and Natalie Mowry in said property was $2,372,361.50. On such date, William Mowry, the owner of 25 per cent of Gyro's outstanding stock, was a man of financial substance who owned ranches and business interests in Mexico. (Tr. 335). Also, on January 1, 1959, it was the intention of Chris and Natalie Mowry to adopt more children, and in fact they later did adopt Marjorie and Alan. (Tr. 332).

On March 20, 1959 Gyro received the condemnation award for the Paloma Street property in the amount of $30,896.65. (R. 50).[28]

After the said purchase of the three improved parcels by Gyro, the latter reported in its federal income tax returns for the taxable period January 1, 1959 to October 31, 1959 and for the taxable period ending October 31, 1960 that its cost basis in the said three parcels of improved real property was the purchase price of $3,194,000 (R. 51, 53, 54 - 55)[29] less the $23,096.65 of gain realized from the condemnation of the Paloma Street property.

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[27] Stipulation of Facts No. 1, pgh. 7 at p. 4.

[28] Stipulation of Facts No. 1, pgh. 9 at p. 5.

[29] Stipulation of Facts No. 1, pghs. 17, 23 and 27.

Subsequently, the Commissioner of Internal Revenue, in a statutory notice of deficiency to Gyro dated December 24, 1963, adopted the conclusions, without setting forth any grounds therefore,[30] (1) that the cost basis to Gyro of the said three parcels of unimproved real property was not the purchase price but the cost basis of Chris and Natalie Mowry, and also (2) that Gyro realized gain of $23,096.65 as a result of the condemnation award for the Paloma Street property. (R. 52,54 - 55).[31] Thereafter on or about April 30, 1964, the claimed deficiencies for the taxable year January 1, 1959 to October 31, 1959 and the taxable year ending October 31, 1960 totalling $84,127.44 plus $19,150.54 of interest were paid by Gryo. (R. 92).[32] Timely claims for refund therefor were filed on October 5, 1964, and the instant suits for refund were filed August 2, 1965. (R. 93, 2).

All issues except the proper cost basis to Gyro of the real property purchased from Chris and Natalie Mowry and whether gain was realized from the condemnation of the Paloma Street property have been resolved by the parties. This appeal is from the decision of the district court that Gyro's cost basis in the said real property is not the purchase price but the former cost basis of Chris and Natalie Mowry, and that Gyro is not entitled to nonrecognition of gain from the Paloma Street condemnation award provided for in Section 1033 of the Internal Revenue Code of 1954.

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[30] R. 105 - 106; Tr. 168, 170 - 172.

[31] Stipulation of Facts No. 1, pghs. 19, 25 and 29.

[32] Stipulation of Facts No. 2, pgh. 38 at p. 14.

SPECIFICATION OF ERRORS RELIED ON

The trial court erred:

1. In denying plaintiff's motion for a ruling that the government had the burden of proof with respect to its contention that there was no sale to Gyro but a contribution to its capital. (R. 150, Tr. 39).

2. In denying plaintiff's motion for a ruling that the statute of limitations had run with respect to the government's contention that there was no sale but a contribution to capital. (R. 147, Tr. 24).

3. In denying plaintiff's motion for a ruling that the government had the burden of proof with respect to its contentions set forth in paragraphs 4, 8, and 11 of paragraph VIII of the pretrial order under the designation "Defendant's issues of law". (R. 150, Tr. 39).

4. In denying plaintiff's motion for a ruling that the statute of limitations had run with respect to the government's contentionsset forth in paragraphs 4, 8, and 11 of paragraph VIII of the pretrial order under the designation "Defendant's issues of law". (R. 147, Tr. 24).

5 - 38. In finding as fact Nos. 8, 10, 12, 13, 16, 19, 20, 23, 25, 28, 29, 30, 31, 32, 33, 34, 36, 37, 39, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50, 51, 52, 53 and 54 of the Findings of Fact. Wherein each finding of fact is erroneous is set forth under each separate finding in Point X, infra, all of which is incorporated herein by reference as follows:

Specification of Error	Finding of Fact
5	8
6	10
7	12
8	13
9	16
10	19
11	20
12	23
13	25
14	28
15	29
16	30
17	31
18	32
19	33
20	34
21	36
22	37
23	39
24	40
25	41
26	42
27	43
28	44
29	45
30	46
31	47

Specification of Error	Finding of Fact
32	48
33	49
34	50
35	51
36	52
37	53
38	54

39. In not ruling that Congress has considered the practice of selling depreciable assets to controlled corporations and has responded with the precise provisions of narrow application set forth in Section 1239 allowing a stepped up basis to a controlled corporation whether or not the gain is ordinary income or capital gain.

40. In not ruling that Gyro purchased the apartments as was stipulated by the government in Stipulation of Facts No. 1.

41. In refusing to enforce the stipulation referred to in 40 above.

42. In finding as fact that Gyro purchased the apartments and then concluding there was so sale by Chris and Natalie Mowry.

43. In not finding that there was a transfer of property for a fixed amount of money herein, and that such is a sale within the meaning of that term as used in the Internal Revenue Code and as interpreted in *Commissioner* v. *Brown*, 380 U. S. 563 (1965).

44. In not finding that the government abandoned its sham argument.

45. In not finding as fact that there was a contribution to capital.

46. In concluding under its Conclusion of Law No. XLI that the sale to Gyro was a contribution to capital.

47. In ruling that the transfer to Gyro was a sham and then ruling there was a transfer which it then labeled a contribution to capital.

48. In applying to the question of whether there was a sale or contribution to capital the seventeen criteria set forth in Conclusions of Law XXI through XXXVIII.

49. In concluding in Conclusion of Law XL that plaintiff had the burden of proving there was a sale and did not carry it.

50. In concluding in Conclusion of Law XLI that the transfer was a sham and must be deemed a contribution to the capital of Gyro.

51. In concluding in Conclusion of Law XLII that Gyro's cost basis in the property acquired January 1, 1959 is limited to the cost basis of Chris and Natalie Mowry.

52. In concluding in Conclusion of Law XLVIII that Gyro did not re-establish its prior commitment of capital.

53. In concluding in Conclusion of Law XLIX that there was no purchase or reinvestment of the condemnation award within the meaning of Section 1033.

ARGUMENT

The decision below not only contravenes several stipulations that Gyro purchased three apartment house developments for a purchase price of $3,164,000, but it refused to follow the decision of the Supreme Court in Commissioner v. Brown, 380 U. S. 563 (1965), was induced by defendant's citation of Murphy Logging Co. v. United States, 239 F. Supp. 794, which was later reversed by this Court, 378 F. 2d 222, constitutes a gross case of judical legislation which nullified the action taken by Congress to deal with sales of depreciable assets to a controlled corporation, and is not supported by the case law interpreting Section 362 (a) (2) of the Internal Revenue Code of 1954, the section relied on by the government and the trial court. Furthermore, the decision below, if allowed to stand, will cause, as shown hereinafter, a monetary loss to Chris and Natalie Mowry of $1,067,580.67 in addition to the tax consequences herein.

I

Where Congress Has Considered The Practice Of Selling Depreciable Assets To Controlled Corporations, And Has Responded With The Precise Provisions Of Narrow Application Set Forth In Section 1239 Which Did Not Deny The Fact Or Occurrence Of A Sale, The Commissioner Cannot, Via The Stratagem Of Contending There Was No Sale, Invade The Policy Of Congress And Thereby Fashion A Broader Rule. Commissioner v. Brown 380 U. S. 563, 578-579 (1965).

Section 1012, Internal Revenue Code of 1954, requires that "the basis of property shall be the cost of such property, except as otherwise provided . . . in subchapter C." If the rule were otherwise and a purchaser of real property for $3,164,000 were required to assume the lower cost basis of the sellers ($805,222.09), such purchaser would be in the untenable economic position, upon a resale for $3,164,000, of having to pay the first seller $3,164,000 of purchase price and having to pay federal income tax of $589,694.47 on a resale gain of $2,358,777.91 occurring more than six months after the purchase.[33] In short, the purchaser would lose $589,694.47 simply as a result of buying the property for $3,164,000 and reselling it for $3,164,000 if he is required to use as his cost the low cost basis of the person from whom he bought rather than the purchase price of $3,164,000.[34] And that is precisely the position Gyro is now in as a result of the trial court's decision that its cost basis is the $805,222.09 of Chris and Natalie Mowry rather than its purchase cost of $3,164,000.

The foregoing is the economic reason why, as will be shown below, Congress refused to change the rules with respect to the cost basis of the purchaser when it legislated in regard to the problem posed by sales of depreciable property to controlled

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[33] Upon a resale of such property for $3,164,000, there would be gain of $2,358,777.91 if the lower cost basis of the seller ($805,222.09) had to be used by the first purchaser for $3,164,000.

[34] Paying $3,164,000 to the first seller plus $589,694.47 of federal taxes upon a resale for $3,164,000 while receiving only $3,164,000 upon the resale results in a loss of $589,694.47.

corporation, and permitted the stepped up cost basis to the transferee corporation to remain undisturbed.[35]

In 1951, after a request from the Commissioner of Internal Revenue,[36] Congress acted with respect to sales of depreciable assets to corporations controlled by the sellers of such assets. The House of Representatives Committee on Ways and Means explained Section 310 of H. R. 4473 as follows:

> "Section 310 of this bill is intended to forestall the practice of selling depreciable assets to controlled corporations in order to obtain the substantial tax benefits available under existing law. This practice which is reported by the Bureau of Internal Revenue to be of growing importance, may be illustrated as follows: Assume that a husband and wife own and operate a corporation engaged in retail trade, that they also own as individuals the building used by this corporation and that the current value of the building is well in excess of its adjusted basis. If the building is sold to the corporation, a capital-gains tax will ordinarily be paid, but the building then has, in the hands of the corporation, an adjusted basis which is greater than the basis in the hands of the individual shareholders by the amount of the gain realized on the

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[35] 3B Mertens, Law of Fed. Tax. § 22.25 at p. 135.

[36] 1951 Cum. Bull. July-Dec. at p. 376; H. R. Rep. No. 586, 82nd Cong., 1st Sess.

sale to the corporation. The property being depreciable the corporation will then be able to write off the increase in the adjusted basis over the remaining life of the building. The resulting additional depreciation charges are, of course, an offset to ordinary income. Thus, in effect, the immediate payment of a capital-gains tax has been substituted for the elimination, over a period of years, of the corporate income taxes on an equivalent amount. The substantial differential between the capital-gains rate and the ordinary rates makes such a substitution highly advantageous when the sale may be carried out without loss of control over the asset because the corporation to which the asset is sold is controlled by the individuals who make the sale.

"Section 310 of this bill eliminates the tax advantage from such transactions by denying capital-gains treatment to the transferor with respect to sales or exchanges of depreciable property between a husband and a wife, or between an individual and a corporation, more than half of the outstanding stock of which is owned by or for him directly or indirectly. For the purpose of determining ownership of stock an individual will be considered as owning a portion of the stock held by a corporation, partnership, estate or trust which reflects his interest as a shareholder, partner or beneficiary. He will also be considered as owning stock owned

> directly or indirectly by or for his spouse and if he and his spouse own more than 10 percent of the outstanding stock of a company he will also be considered as owning stock held directly or indirectly, by or for his brothers and sisters, ancestors and lineal descendants." 1951 Cum. Bull. July-Dec. at p. 376; H. R. Rep. No. 586, 82nd Cong., 1st Sess. Further explanation is found at 1951 Cum. Bull. July-Dec. at pp. 444-445.

Later in 1951 the Senate's Committee on Finance, in Sen. Rep. No. 781, refused to approve Section 310 of the House of Representatives 4473, and eliminated the House provision from the Senate Bill. 1951 Cum. Bull. July-Dec. at p. 507, Sen. Rep. No. 781, 82nd Cong., 1st Sess.

Thereafter, in 1951, after conferences between the managers of House of Representatives bill and the managers of the Senate amendments, it was agreed that both would recommend to their respective Houses with respect to Section 310 of H. R. 4473 that:

> "The House recedes with an amendment which adds a new subsection (o) to section 117 of the Internal Revenue Code so as to provide that in the case of a sale or exchange, directly or indirectly, of depreciable property (1) between husband and wife, or (2) between an individual and a corporation in which he, his spouse and his minor children and minor grandchildren own more than 80 percent of the value of the outstanding stock, any gain recognized to the transferor shall be considered ordinary income and not capital gain." (Underscoring supplied) 1951 Cum. Bull. July-Dec. at p. 631,

H. R. Rep. No. 1213, 82nd Cong., 1st Sess.

In short the legislative process in Congress refused to enact into law the provisions of the House of Representatives' bill that a sale of depreciable property was to be denied capital gain treatment if the transferor owned more than 50 percent of the corporation's stock and that if such seller owned more than 10 percent of the corporation's stock then any stock owned by his brother was to be added in determining whether such transferor's stock equalled the percentage required before capital gain treatment was denied. Rather it was agreed by the two Houses that in order for the law to deny capital gain treatment on the sale of depreciable property to a controlled corporation, the transferor and his <u>minor</u> children and <u>minor</u> grandchildren had to own at least 80 percent of the value of such corporation's stock, and in computing such percentage the stock owned by such transferor's brother could not be included. Furthermore, the Congress stamped its approval on the capital gain status of such a sale of depreciable property even where the transferor and his adult children owned all of the outstanding stock.

Thus, Section 117 (o) of the 1939 Internal Revenue Code was enacted embodying the above agreement reached by the House of Representatives and the Senate.[37] Section 117 (o) remained

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[37] Section 117 (o), Internal Revenue Code of 1939 provides:

"(o) Gain From Sale of Certain Property Between Spouses or Between an Individual and a Controlled Corporation. -

(1) Treatment Of Gain As Ordinary Income. - In the case of a sale or exchange directly or indirectly of property described in paragraph (2) -

unchanged in the 1954 Internal Revenue Code as Section 1239. Neither in 1951 nor later did Congress attempt to deal with the tax consequences of sales of depreciable property to controlled corporations by changing the fundamental rules that the cost basis of such property to the transferee corporation is its purchase price.

Nevertheless, after Congress was persuaded by the Bureau of Internal Revenue to legislate respecting "the practice of selling derpeciable assets to controlled corporations",[38] and did so by permitting the stepped-up cost basis but denying capital gain treatment only to transferors who held <u>certain</u> stock interests in the acquiring corporation, the Commissioner of Internal Revenue now seeks, by contending that such a transfer is a sham and therefore a contribution to capital under Section 362 (a) (2), to render meaningless the precise provisions with narrow application which Congress chose to deal with the problem.

In <u>Commissioner</u> v. <u>Brown</u>, 380 U. S. 563 (1965), where the Supreme Court rejected arguments by the Commissioner that the transaction there"did not have the substance of a sale" within the meaning of the Internal Revenue Code (page 570), it first held that the word "sale" as used in the Internal Revenue Code

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> (A) between a husband and wife; or
> (B) between an individual and a corporation more than 80 per centum in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren;
>
> any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j). . ."

[38] Id at n. 36.

was to be given its ordinary meaning which was "a transfer of property for a fixed price in money or its equivalent" and then, at pages 578-579, gave an equally important reason for rejecting the Commissioner's arguments:

> "There is another reason for us not to disturb the ruling of the Tax Court and the Court of Appeals. In 1963, the Treasury Department, in the course of hearings before the Congress, noted the availability of capital gains treatment on the sale of capital assets <u>even though the seller retained an interest in the income produced by the assets</u>. The Department proposed a change in the law which would have taxed as ordinary income the payments on the sale of a capital asset which were deferred over more than five years and were contingent on future income. Payments, though contingent on income, required to be made within five years would not have lost capital gain status nor would payments not contingent on income even though accompanied by payments which were. Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. I (rev.), on the President's 1963 Tax Message, pp. 154-156.
>
> "Congress did not adopt the suggested change but <u>it is significant</u> for our purposes <u>that</u> the proposed <u>amendment did not deny the fact or occurrence of a sale</u> but would have taxed as ordinary income those income-contingent payments deferred for more than

five years. If a purchaser could pay the purchase price out of earnings within five years, the seller would have capital gain rather than ordinary income. The approach was consistent with allowing appreciated values to be treated as capital gain but with appropriate safeguards against reserving additional rights to future income. In comparison, the Commissioner's position here is a clear case of "overkill" if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises There are more precise approaches to this problem as well as to the question of the possibly excessive price paid by the charity or foundation. And if the Commissioner's Approach is intended as a limitation upon the tax treatment of sales generally, it represents a considerable invasion of current capital gains policy, a matter which we think is the business of Congress, not ours.

"The problems involved in the purchase of a going business by a tax-exempt organization have been considered and dealt with by the Congress. Likewise, it has given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations, it has responded, if at all, with precise provisions of narrow application. We consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event,

must have wide ramifications.' American Automobile Ass'n. v. United States, 367 U. S. 687, 697." (Underscoring supplied)

Likewise, the problems involved in the practice of selling depreciable assets to controlled corporations in order to obtain a stepped-up cost basis were considered and dealt with by the Congress. It responded with precise provisions of narrow application set forth in Section 1239 which was formerly Section 117 (o). In doing so it did not deny the fact or occurrence of a sale but taxed as ordinary income the payments received by any sellers if the latter owned 80 per centum or more of the purchasing corporation's stock.

The foregoing holding of Commissioner v. Brown, supra, makes it clear that where Congress has considered and dealt with the problems involved in the selling of depreciable assets to corporations in which the seller has some measure of control, and has responded with precise provisions of narrow application, the Commissioner cannot, via the stratagem of contending there was no sale, invade the policy of Congress and fashion a broader rule in order to prevent the stepping-up of cost basis of depreciable assets. Congress, which has been legislating with respect to tax avoidance problems for over a half a century, knows what it is doing. It is not within the Commissioner's power to usurp the function and power of Congress.

In the instant case it was stipulated by the government that Chris Mowry's adult brother, William Mowry, paid for and owned 25 per centum of Gyro's outstanding stock from April 20, 1953 through January 1, 1959 (the date when Gyro purchased the improved

real property) and to at least April 29, 1966. Thus, the Commissioner of Internal Revenue could not under Section 1239 treat the gain realized by Chris and Natalie Mowry on the January 1, 1959 purchase by Gyro as ordinary income since Chris and Natalie Mowry did not own more than 80 per centum of Gyro's outstanding stock.

Therefore, what should the Commissioner of Internal Revenue do? Abide by the limitations of the law (Section 1239) enacted after a compromise between the House of Representatives and the Senate, or try to defeat Congress with judicial approval? In the words of the Commissioner's agent who prepared the notice of deficiency herein (Tr. 164), the sale from the Mowrys to Gyro was "considered to be a contribution to capital" under "the provisions of Section 362 (a) (2)" because there was "no requirement for stock control or ownership under that Section." (Tr. 196).

II

The Government Stipulated Herein That Gyro Purchased The Real Property On January 1, 1959, While Paragraph III Of The Pretrial Order Provided That No Proof Of That Fact Was Required, And Hence The Trial Court Erred In Finding That There Was No Sale But A Capital Contribution.

On May 11, 1966, the government filed Stipulation No. 1 in the trial court (R. 46). That stipulation begins by stating:

> "It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel,

> that the facts hereinafter stated shall be taken as true for the purposes of this action. . . ."

There is no provision or qualification therein that such facts set forth a sham or are true in form only or describe only the form of the transaction. Nor are there quotation marks around the words hereinafter relied on by appellant.

At page 5 of Stipulation No. 1, at lines 13 through 17 (R. 50), the government stipulated that the following shall be taken as true:

> "Gyro Engineering Corporation purchased from Chris and Natalie Mowry three (3) parcels of improved real property known and referred to respectively as (1) "The Tropics", (2) "The Carousel", and (3) the "Orange Grove Circle Apartments". (Underscoring supplied).

There is no language anywhere in such stipulation stating that Gyro did not purchase the said property but received it as a contribution to capital.

Thereafter, in the same stipulation, after reciting that Chris and Natalie Mowry conveyed the real property on the same day, January 1, 1959, at page 6, at lines 23 and 24 (R. 51) the government stipulated that the following shall be taken as true.

> "The total purchase price of the Tropics was allocated by Gyro Engineering Corporation as follows:" (Underscoring supplied).

Also, at page 8 of the same stipulation, at lines 20 and 21 (R. 53) the government stipulated that the following shall be taken as true:

> "The total purchase price of the Carousel was

> allocated by Gyro Engineering Corporation as follows:" (Underscoring supplied).

And again, at page 9 of the same stipulation, at lines 25 through 31 (R. 54), the government stipulated that the following shall be taken as true:

> "Gyro Engineering Corporation subtracted from the total <u>purchase</u> price of the South Orange Grove Apartments the sum of $23,096.65 which was the amount of the gain realized from the condemnation of the Paloma Street property, referred to in Paragraph 8 and 9 above, and allocated the balance of the <u>purchase</u> price, or $2,636,903.65 as follows." (Underscoring supplied).

Nor is there any language in the said stipulation qualifying the above reference to the purchase by Gyro.

Subsequently, in the pretrial order filed June 20, 1966, at paragraph III on page 2 thereof, the following is found:

> "The facts set forth in Stipulation of Facts Number One and Stipulation of Facts Number Two are admitted <u>and require no proof</u>." (Underscoring supplied).

Paragraph IV of the pretrial order contains no reservation by the government to above referred to stipulated facts. Since the government stipulated, as shown above, that "Gyro Engineering Corporation <u>purchased</u> from Chris and Natalie Mowry" the three parcels of real property, paragraph III of the pretrial order provided that appellant was not required to prove that "Gyro Engineering Corporation purchased from Chris and Natalie Mowry" the three parcels of real property.

At the opening of the trial on November 22, 1966, Stipulation of Facts No. 1 was admitted into evidence without objection by the government except as to the reservations set forth in paragraph IV of the pretrial order, none of which are directed to the stipulation that Gyro purchased the three parcels of real property (Tr. 39-41). During the trial, no request was made by the government to be relieved from the said stipulation that Gyro purchased the three parcels or from the provision of the pretrial order that such fact was admitted and required no proof by Gyro.

Therefore, it was error for the trial court to find that Gyro did not purchase the three parcels, that the sale was purported, that it was a sham, and was instead a contribution to Gyro's capital (R. 634, 747). The law is clear that parties may validly stipulate as to evidential matters, and stipulate to dispense with the necessity of evidence to prove designated facts. _Great Northern R. Co._ v. _U. S._, 318 U. S. 262. Courts are bound to enforce stipulations which parties may validly make which do not violate public policy. _McGrath v. Tadayasu Abo_, C. A. Cal., 186 P. 2d 766; _Morse Dry Dock & Repair Co._, 291 N. Y. S. 995, 249 App. Div. 794; _Esch_ v. _Forster_, 123 Fla. 905, 168 So. 229. Courts have no power to make findings contrary to the terms of a stipulation. _Capitol National Bank of Sacramento_ v. _Smith_, 62 Cal. App. 2d 328, 144 P. 2d 665, or render a judgment not authorized by its terms. _Miskind_ v. _Superior Court in and for Fresno County_, 81 Cal. App. 2d 360, 183 P. 2d 95.

Furthermore, Finding of Fact 53 (R. 727), signed by the trial court, only serves to illustrate the grossness of the error. That finding stated:

> "The occasional uses of the word 'purchase' in the stipulation of fact were not intended to be, nor are they, stipulations that the transaction was a bona fide sale for federal income tax purposes. Such uses of the word 'purchase' were meant to refer to the form of the transaction, and not to its substance for purposes of federal tax law."

Aside from the incongruity of finding that words used in a stipulation filed in a federal tax refund case are not meant to refer to the nature of the transaction for federal tax purposes, there are other good reasons why such a finding herein is error.

There is not one iota of evidence to support such finding of fact. No testimony was introduced by the government at the trial nor was documentary evidence introduced with respect to the meaning of the stipulation. What did happen was that _after_ the trial was completed and the record closed, appellant presented full oral argument to the trial court that the government had stipulated that Gyro purchased the real property. (Tr. 631-635). Possibly because a stipulation cannot be repudiated or withdrawn from by one party without the consent of the other, except by leave of the court on _cause_ _shown_,[39] and this is especially true after it has been so acted on that the parties cannot be placed

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[39] Jones v. U. S., 7 Cir., 1934, 72 F. 2d 873; General Electric Co. v. Wagner Electric Mfg. Co., C. C. S. D. N. Y. 1903, 123 F. 101, Aff'd. 130 F. 772; Gonzales v. Pacific Greyhound Lines, 34 Cal. 2d 749, 214 P. 2d 809; Palmer v. City of Long Beach, 33 Cal. 2d 134, 199 P. 2d 952; Andrew v. Bankers' & Shippers' Ins. Co. of New York, 125 Cal. App. 24, 13 P. 2d 515.

in statu quo,[40] the government never filed a post-trial motion or proceeding to be relieved from the stipulation. Instead, nearly two and one-half months later, as an appendix to its brief, the government's advocate who signed the stipulation and also tried the case, submitted, as an appendix to the government's brief, a self-serving argument in the form of an affidavit that it was not his understanding or intention to stipulate that Gyro purchased the improved real property. (R. 480).

The courts have power to relieve the parties from a stipulation upon a proper application and a showing of sufficient cause. Palmer v. City of Long Beach, 33 Cal. 2d 134, 199 P. 2d 952, 956. However, proper application is required,[41] and relief will be denied where the stipulation has been acted on so that the parties cannot be placed in statu quo,[42] or where one of the parties has received a benefit from the agreement,[43] or where an undue advantage would result in favor of the party seeking the relief,[44] or where the setting aside of the stipulation would result in serious injury to the other party.[45] Here the government

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[40] Johnson v. Wright, 19 Ga. 512.

[41] A party to a stipulation who desires to have it set aside should seek to do so by a direct proceeding, usually by a motion on notice. Chicago v. Drexel, 30 N. E. 774, 141 Ill. 89; Dunscombe v. Smith, 139 Fla. 497, 190 So. 796: In order to obtain relief against stipulation, regular course is not to ignore or attempt to evade it, but to make seasonable affirmative application to court on formal motion on notice; Kristel v. Steinberg, 69 N. Y. S. 2d 476, 188 Misc. 500.

[42] Bond v. Bond, 24 N. Y. S. 2d 169, 260 App. Div. 781.

[43] C. J. p. 95 note 41.

[44] Liebernecht v. Great Northern R. Co., 110 Minn. 457, 126 N. W. 71.

[45] Clark v. Delaware & H. R. Corp., 283 N. Y. S. 739, 245 App. Div. 447.

did not file a proper application to be relieved, and therefore the stipulation is binding. However, even if it had done so, it would have been error to relieve the government, <u>after the trial</u>, of its stipulation that Gyro purchased the improved real property and its agreement that such fact was admitted and required no proof by appellant.

III

<u>Since Neither The Evidence Nor Procedure Below Nor Law Permit The Trial Court To Modify The Stipulation That Gyro Purchased The Real Property, It Erred In First Finding That Gyro Purchased Said Property And Then Concluding It Did Not</u>

In Finding of Fact No. 2 the trial court found as follows:

> "The Court accepts and finds specifically the facts stipulated in Stipulation of Facts No. 1 and Stipulation of Facts No. II (both stipulations as modified in minor detail at trial and noted by the Clerk <u>and as interpreted</u> herein), and the pretrial order, and incorporates said stipulations and pretrial order herein by reference to the extent same are relevant to any issue herein."

Since the previously discussed "interpretation" of the stipulation that Gyro did not purchase the real property is error it follows that the trial court has found above, by adopting the stipulated facts, that Gyro purchased the improved real property. Therefore, its conclusion of law that Gyro did not purchase the

said property but received same as a contribution to capital is contradicted by its specific findings and is in error. An ultimate finding which is contrary to the evidence is erroneous.

IV

Commissioner v. Brown, 380 U. S. 563 (1965) Requires A Reversal Of The Trial Court Finding That There Was No Sale Of Real Property From Chris And Natalie Mowry To Gyro.

The case of Commissioner v. Brown, 380 U. S. 563 (1965), was, as the opinion stated at page 566, one of the many in the course of which the Commissioner of Internal Revenue questioned whether there had been a sale within the meaning of the Internal Revenue Code. In fact, when the Commissioner petitioned for a writ of certiorari, after this Court had held there was a sale, he told the Supreme Court therein that it was one of the most important tax cases that had ever come to the Court, that "there now exists among the lower courts no core of agreement even as to the most generalized concept of what a sale meant", and that the Supreme Court should tell the lower courts what the word "sale" meant as used in the Internal Revenue Code (Tr. 639-640). The Supreme Court took the case.

In the briefs filed by the parties, it was pointed out to the Supreme Court that the approach the Commissioner was attempting by giving the word "sale" a different meaning in federal tax law than its ordinary meaning, was affecting a multitude of transactions and had a host of adverse effects because the word "sale" appeared over 600 times in subchapter A alone.

The facts in *Commissioner* v. *Brown*, supra, were that the stockholders of Clay Brown & Co. agreed to sell their stock to the Institute for $1,300,000 payable *$5,000 down* from the very assets of Clay Brown & Co. and the balance *from the earnings* of the company's assets. It was agreed that simultaneously with the transfer of the stock, the Institute would liquidate Clay Brown & Co. and lease its assets to a new corporation *wholly owned* by the attorneys for Clay Brown & Co. The new corporation would pay the Institute 80 percent of its operating profit of which 90 percent thereof would be paid by the Institute to the selling shareholders as payments on the purchase price of the stock. The Institute's note for $1,300,000 to pay for the stock of Clay Brown & Co. was not only *noninterest bearing* but the Institute had *no obligation to pay it* except from the said rental income. The $1,300,000 note was *secured by mortgages and assignments* of the assets transferred from Clay Brown & Co.'s liquidation to the new corporation. If the payments on the note failed to total $250,000 over any two consecutive years, the sellers could declare the entire balance of the $1,300,000 note signed by the Institute to be *due* and payable. Clay Brown was to have a *management contract* with the new corporation at an annual salary and the *right to name any successor* if he himself resigned. And Clay Brown's personal liability for some of the indebtedness of Clay Brown & Co., assumed by the new corporation, was continued. He also personally guaranteed some additional indebtedness incurred by the new corporation. See footnote 3.

On the day the sale transaction was closed, the new corporation immediately took over operation of the business under its

lease, on the same premises and with practically the same personnel which had been employed by Clay Brown & Co. Within four and one-half years the new corporation suffered financial reverses and its operations were terminated, but the sellers of the Clay Brown & Co. stock did not repossess the assets under the mortgage but agreed they could be sold by the Institute with the latter retaining 10 percent of the proceeds. The payments on the $1,300,000 note from rentals paid by the Institute plus the sale proceeds totaled $936,131.85.

The Supreme Court then responded to the Commissioner's petition that it tell the lower courts what the word "sale" meant as used in the Internal Revenue Code.

First, it noted, at page 570, the Commissioner's argument:

> "Whatever substance the transaction might have had, however, the Commissioner claims that it did not have the substance of a sale within the meaning of § 1222 (3). His argument is that since the Institute invested nothing, assumed no independent liability for the purchase price and promised only to pay over a percentage of the earnings of the company, the entire risk of the transaction remained on the sellers. Apparently, to qualify as a sale, a transfer of property for money or the promise of money must be to a financially responsible buyer who undertakes to pay the purchase price other than from the earnings or the assets themselves or there must be a substantial down payment which shifts at least part of the risk to the buyer and furnishes some cushion against loss to the seller." (Underscoring supplied).

Next, the Supreme Court rejected the above argument, and gave its reasons:

> ". . . This argument has rationality but it places an unwarranted construction on the term 'sale', is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it."

Immediately thereafter, the Supreme Court told the lower courts what the word "sale" meant as used in the Internal Revenue Code. It held:

> "'Capital gain' and 'capital asset' are creatures of the tax law and the Court has been inclined to give these terms a narrow, rather than a broad construction. Corn Products Co. v. Commissioner, 350 U. S. 46, 52. A 'sale', however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code. 'Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words 'sale' and 'exchange' are not to be read any differently.' Helvering v. Flaccus Leather Co., 313 U. S. 247, 249; Hanover Bank v. Commissioner, 369 U. S. 672, 687; Commissioner v. Korell, 339 U. S. 619, 627-628; Crane v. Commissioner, 331 U. S. 1, 6; Lang v. Commissioner, 289 U. S. 109, 111; Old Colony R. Co. v. Commissioner, 284

U. S. 552, 560.

> "'A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent,' Iowa v. McFarland, 110 U. S. 471, 478; it is a contract to pass rights of property for money,--which the buyer pays or promises to pay to the seller . . .,' Williamson v. Berry, 8 How. 495, 544. Compare the definition of 'sale' in § 1 (2) of the Uniform Commercial Code. The transaction which occurred in this case was obviously a transfer of property for a fixed price payable in money." (**Underscoring supplied**).

Thus, the Supreme Court flatly rejected the government's argument that the term "sale" as used in the Internal Revenue Code is to receive some special interpretation reserved only for federal tax law,[46] and ruled that the term "sale" is to be given

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[46] Compare the rule laid down by the Supreme Court with the following arguments made by the government to the trial court herein:

> "We feel that state law determines the ownership of property. Under state law there is a corporation. There was a valid transfer to that corporation.
>
> "So that all we are saying is that for tax purposes that corporation is not entitled to the stepped-up basis which it claims. That is all we are saying." (Tr. 711)
>
> "Tax law sometimes becomes--must become, by virtue of the special concepts used--somewhat separate from the state law consequence.
>
> "We are construing a highly abstract and particularized statute. That is all we are doing here.
>
> "Was this a sale within the terms of the Internal Revenue Code - not whether this is a sale otherwise." (Tr. 715)
>
> "It should go without saying that the legal ramifications of a transaction for federal tax purposes are not necessarily the same for State corporation or property law purposes." (R. 500)

its ordinary meaning--a transfer of property for a fixed price in money or its equivalent.

Applying here the Supreme Court's definition of "sale" as a transfer of property for a fixed price in money or its equivalent, it follows that there was a sale by the Mowrys and a purchase by Gyro.

At paragraph 13 of Stipulation of Facts No. 1 (R. 50), adopted as a finding of fact by the trial court (R. 707), it is set forth that:

> "On January 1, 1959, Chris Mowry and Natalie Mowry conveyed by a Grant Deed three (3) parcels of improved real property known and referred to respectively as (1) 'The Tropics', (2) 'The Carousel' and (3) the 'Orange Grove Circle Apartments.'"

Also, the government conceded that there "was a valid transfer to" Gyro. (Tr. 711). Thus, there is no debate about the fact that there was a transfer of property to Gyro

Similarly, paragraph 10 of Stipulation of Facts No. 1 (R. 50), also adopted as a finding of fact (R. 707), recites that on January 1, 1959, Chris and Natalie entered into a written Sales and Purchase Agreement with Gyro, a copy of which is Exhibit 4 (R. 50, 71). That agreement provides that the fixed price to be paid by Gyro for said property was $3,164,000. (R. 71)

Since there was a transfer of property from Chris and Natalie Mowry to Gyro for a fixed price in money, there was a sale within the definition of that term as handed down by the Supreme Court. Commissioner v. Brown, supra.

Because the Supreme Court was asked to tell the lower court what the word "sale" meant as used in the Internal Revenue Code,

and in fact did so in Commissioner v. Brown, supra, the definition thereof handed down cannot be dismissed simply by arguing that the transaction in Brown was different than the transaction in another case. The facts of each case naturally differ but the meaning given to the word "sale" in Commissioner v. Brown, supra, does not change until the Supreme Court changes it. Surely one of most important tax cases ever to come before the Supreme Court cannot, once it has been lost by the government, be so relegated to the status of an ad hoc decision limited to the facts of that case.

Thus, the trial court below erred in concluding that Brown is "distinguishable" because the transaction there "was negotiated only after considerable good faith bargaining at arm's length" whereas here "Chris Mowry effectively dealt only with himself." (R. 746). How does such a "distinction" change the fact that the Supreme Court decided in Commissioner v. Brown, supra, what the word "sale" meant as used in the Internal Revenue Code, and that it means a transfer of property for a fixed sum of money? In the first place, the language quoted by the trial court from Commissioner v. Brown, supra, was from that part of the Supreme Court's opinion which recited what the Tax Court had found below. There is nothing in the Supreme Court's opinion which holds that a sale is a transfer of property for a fixed amount of money only where there has been considerable good faith bargaining at arm's length between the seller and buyer. Presumably this would mean that there can never be a sale between anyone owning more than 50 per centum and up to 80 per centum of a corporation's stock since such seller would also be dealing

with himself according to the government's reasoning, and therefore there cannot be a capital gain sale of depreciable assets to a corporation whether or not the seller owns less than 80 per centum of its stock. In short, the government "reasoning" neatly defeats the decision of Congress in Section 1239 that capital gain would only be disallowed if the seller of such assets owned 80 per centum or more of the controlled corporation's stock.

What the Supreme Court did say in Commissioner v. Brown, supra, with respect to limiting the word "sale" was that the courts have some "scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results. . . or would thwart the obvious purpose of the statute." 380 U. S. 571. But how can it be said that the usual meaning of "sale" would thwart the obvious purpose of the statute when, as shown above in I, the obvious purpose of the statute was to permit the acquiring controlled corporation to obtain a stepped-up basis whether or not the sellers owned 80 per centum or more of its stock. If the sellers owned 80 per centum or more, the sellers were not entitled to capital gain, but the controlled corporation purchaser still obtained a new stepped-up basis. If the sellers owned less than 80 per centum of the controlled corporation purchaser, the sellers received capital gain, and the controlled corporation purchaser also obtained the new stepped-up basis. That is, the obvious purpose of the statute could not be thwarted here by giving "sale" its usual meaning because the obvious purpose of the statute is that the controlled corporation purchaser is to receive a new stepped-up basis regardless of whether the seller is denied

capital gain treatment under Section 1239 or not.

While it is doubtful that the Supreme Court opinion would support the holding that an absurd result would be reached or tne policy of Congress defeated if the purchase price was not within a reasonable range of the fair market value of the property sold,[47]

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[47] The Commissioner's contention that the purchase price was excessive in Brown v. Commissioner, supra, was a part of his risk-shifting argument, all of which was rejected at pages 574-575 of the opinion. He had contended that if the seller continues to bear all of the risk and the buyer none, the seller must be collecting a price for his risk-bearing in the form of an interest in future earnings over and above what would be a fair market value of the property. Thus, he said, since the seller bears the risk, the so-called purchase price must be excessive and must be simply a device to collect future earnings at capital gains rates. 380 U. S. 573.

It is true that the Supreme Court went on to point out that the price paid therein was within a reasonable range of the fair market value of the property, 380 U. S. 569, 574, but it also followed shortly with the ruling that:

> "Furthermore, risk-shifting of the kind insisted on by the Commissioner has not heretofore been considered an essential ingredient of a sale for tax purposes." 380 U. S. 574.

Therefore, it is extremely doubtful that the Supreme Court ruled that an absurd result would be reached or the policy of Congress defeated if the purchase price paid was not within a reasonable range of the fair market value.

The above conclusion is buttressed by the concurring opinion of Mr. Justice Harlan who pointed out the incongruity of the Commissioner's all or nothing approach suggesting that:

> "The force underlying the Government's position is that the respondents did clearly retain some risk-bearing interest in the business. Instead of leaping from this premise to the conclusion that there was no sale or exchange, the Government might more profitably have broken the transaction into components and attempted to distinguish between the interest which respondents retained and the interest which they exchanged. . . ."

That is, Mr. Justice Harlan also refused to limit the word "sale", but suggested to the government that in examining the seller's tax consequences, it might be wise not to continue with the questionable logic of concluding there is no sale if a seller retains some risk-bearing interest in the asset sold, recognize that a sale occurred, and place a value on that part of the price, if any, which exceeds the fair market value, and tax that portion to the seller as ordinary income.

and therefore the usual definition of a sale as a transfer of property for a fixed amount of money need not be applied, such a holding would not adversely affect the taxpayer herein. The reasons are found in the record and findings herein.

The Court may have noticed that while appellant orally argued and briefed its view that the sale price of $3,164,000 was within a reasonable range of the fair market value of the real property on January 1, 1959 (Tr. 646; R. 348, 623), there is no finding of fact that such price was not within "a reasonable range" of the fair market value. Nor is there a finding that the price was grossly excessive or twice the fair market value. 380 U. S. 574 at footnote 7. Instead, there is the evasively worded Finding of Fact No. 47 that:

> "Both plaintiff and defendant presented expert evidence on the fair market value of the properties at the time of the transfer. While this evidence is in part conflicting, after careful consideration the Court is inclined to the view that the recited 'price' was somewhat excessive in relation to fair market value."
> (R. 726).

This finding is subject to fatal defects.

First, the Court is asked to note that the trial court does not find as fact that the purchase price was somewhat excessive. It simply finds as fact that it (the trial court) is "inclined to the view" that it was "somewhat" excessive. Second, even if it were a finding that the price was "somewhat" excessive, such a finding is not the equivalent of a finding that the purchase price was not within a reasonable range of the fair market value.

And what does somewhat excessive mean? Excessive by $1 or $1,000,000?

There are good reasons in the record why the above finding was worded by the government in such meaningless fashion. They are:

(1) The government's "expert" testified on cross-examination that he himself would have bought the real property for $3,164,000. (Tr. 601-602, 604).

(2) The trial court rejected a summary of Mr. Halstead's testimony as evidence (Tr. 609) after hearing him testify he would buy the property for $3,164,000, while admitting such a summary from Gyro's qualified expert, Mr. John Vaughn. (Tr. 93).

(3) The government's "expert" was not an expert at all but a U. S. Internal Revenue Agent who was not a member of the Appraisal Institute.

(4) The government's "expert" was not an expert at all (Tr. 548-549) but a U. S. Internal Revenue Agent (an employee of the Commissioner and therefore a biased witness).

(5) The main purpose for which the testimony of the government's "expert" was offered was not with respect to fair market value, but as an "expert" on sham transactions. (Tr. 542).

(6) Gyro's expert on fair market value, Mr. John Vaughn, of the nationally known Los Angeles based firm of Marshal & Stevens, Inc., who has been hired many times to testify as an expert on valuation by the Commissioner of Internal Revenue and the Department of Justice in tax cases, and who had made between 500 and 700 appraisals of real property since 1936, and who had appraised between 10,000 and 12,000 apartments on 21 housing projects

(Tr. 46-55) valued the improved real property herein at $2,985,000 on January 1, 1959 on the basis of a cash sale (Exhibit 1; Tr. 77, 86, 90-91, 105-106).

(7) When the government attached as Appendix L to its post trial brief a copy of the summary of the testimony of the government's "expert" on fair market value which had been rejected as proper evidence, the trial court, upon motion of Gyro, struck the Appendix from said brief and ordered the Clerk to return it. (R. 542-543, 633).

The foregoing shows why the government did not submit a finding that the purchase price of $3,164,000 was not within a reasonable range of the fair market value on January 1, 1959. Such a finding would be clearly erroneous. And since the said finding which was made is not a finding, not sufficient to support a conclusion that the purchase price of $3,164,000 was not within a reasonable range of the fair market value, and not supported by the record, it follows that the government cannot avoid Commissioner v. Brown, supra, on the ground that here there was a purchase price which was not within a reasonable range of the fair market value.

V

The Government Abandoned Its Sham Argument Prior To Trial And The Trial Court Therefore Erred In Finding The Transfer Was A Sham

The Supreme Court in Commissioner v. Brown, 380 U. S. 563 (1965) stated, at page 569, that:

> "Having abandoned in the Court of Appeals the argument that this transaction was a sham, the Commissioner now admits that there was real substance inwhat occurred between the Institute and the Brown family. The transaction was a sale under local law."

Conversely, once the Commissioner concedes there was a sale under local law, he has abandoned his argument that the transaction was a sham. Here the government conceded in its pretrial memorandum that "defendant recognizes the validity of the transfer to Gyro Engineering Corporation under California law." (R. 241). Hence, since it conceded the transfer was a sale under California law, it in effect abandoned the contention that the transfer was a sham. Appellant realizes that the government herein tried to combine the two by saying the transfer was a sale under California law but nevertheless was a sham under federal tax law. What appellant wishes to emphasize is that both the Supreme Court and the Commissioner, in Commissioner v. Brown, supra, recognized clearly that the sham argument was of necessity abandoned once it was conceded that the transaction was a sale under California law.

VI

The Trial Court Erred In Ruling The Transfer From The Mowrys To Gyro Was A Sham And Then Ruling That There Was A Transfer Which Was A Capital Contribution

The trial court's basic ruling below was made on March 22, 1967 after the filing of briefs. (R. 634). It was that:

> "The transfer from the Mowrys to Gyro of the

> apartment houses was a sham, without substance, and therefore for income tax purposes was merely a contribution to the capital of Gyro."

That is, the trial court first ruled there was no transfer because the purported transfer was a sham, and "therefore" was a contribution to Gyro's capital. But if there was no transfer to Gyro because the purported transfer was a sham, how could there be a transfer which constituted a capital contribution?

In Commissioner v. Brown, supra, it made some sense for the Commissioner to assert deficiencies against the "sellers", contend that the transfer to the Institute was a sham, and that therefore the "sellers" were still receiving the profits from Clay Brown & Co. However, here the Commissioner asks the Court to hold with respect to the "buyers" (the Institute in Brown), that the transfer was a sham but nevertheless really occurred because there was a capital contribution to Gyro. Would the Supreme Court have ever ruled in Commissioner v. Brown, supra, that the transfer or sale to the Institute was a sham requiring the sellers to pay ordinary income tax on the profits from Clay Brown & Co.'s assets, and at the same time rule that the Institute also was required to pay income tax on those same profits if Congress had imposed a 20 per cent tax on an exempt organization's profits?

What has happened here is that the Commissioner and the trial court are trying to have it both ways at once. If the transfer was a sham for federal tax purposes, then Gyro cannot, for federal tax purposes, be treated as having the income from the apartments.

VII

The Trial Court Made No Finding That Chris And Natalie Mowry Intended To Make A Capital Contribution Nor Would The Record Support Such A Finding, And Hence The Conclusion That They Made A Contribution To Capital Is Erroneous.

During the trial the government placed into evidence the testimony of the author of the notice of deficiency herein to prove that the basis of its case was that Gyro had received the apartments not as a result of a sale but as a contribution to capital under Section 362 (a) (2). (Tr. 213). Thereafter, in the critical Conclusion of Law No. XLII, the trial court cited Section 362 as its authority for its conclusion that Gyro's cost basis is limited to the cost basis of Chris and Natalie Mowry. (R. 747).

Section 362 (a) provides as follows:

> "(a) Property Acquired by Issuance of Stock or As Paid-In Surplus. - If property was acquired on or after June 22, 1954, by a corporation -
>
> (1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or
>
> (2) as paid-in surplus or as a contribution to capital,
>
> then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of

gain recognized to the transferor on such transfer."

Since the trial court expressly refused to make a ruling that Section 351 applied (R. 747), probably because it applies only if the transferors own at least 80 per centum of all classes of stock of the acquiring corporation's stock (Sections 351 (a) and 368 (c)) whereas here the government had stipulated that Chris Mowry's adult brother William had owned 25 per centum at the date of transfer (R. 48-49), it is plain that the trial court had to invoke Section 362 (a) (2) particularly since it is the only section dealing with cost basis of a capital contribution.

However, there are several reasons why Section 362 (a) (2) cannot be applied here.

First, there cannot be a capital contribution because as shown heretofore, there was a transfer of property for a fixed amount of money, and hence a sale. There being a sale, the transfer cannot be a capital contribution. Also, for the other reasons set forth heretofore, there was a sale by Chris and Natalie Mowry to Gyro, and therefore no capital contribution.

Second, there cannot be a capital contribution because there was no finding by the trial court that it was the intention of Chris and Natalie Mowry to make a capital contribution. Whether that intent may be determined from objective data or only from the subjective intent of Chris and Natalie Mowry, the fact remains that the trial court made no finding that such was their intention. In Conclusion of Law No. IV, the trial court engages in a general discussion of the requisite intent, and states that whether Chris and Natalie Mowry made a capital contribution involves "objective intent." Yet the conclusion does not state

that such was their intent nor does any other. The reason is that the record here would not support such a finding.

The definition of a capital contribution is just as simple as it sounds. It is a contribution or gift or donation to the capital of a corporation. Thus, the Accountants Handbook, 4th Ed., edited by Wixon, at 21.24, states in discussing the sources of a corporation's capital that:

> "Both tangible and intangible property may be donated to the corporation by either stockholders or outsiders. . . Newlove and Garner (Advanced Accounting) indicate that gifts to the corporation by stockholders should be classified as paid-in capital, . . ."

That is, a contribution to capital is a gift or donation to the corporation's capital structure against which the donor has no claim.

Here Chris and Natalie Mowry owned apartment house at the beginning of January 1, 1959 against which there was mortgage indebtedness of $791,638.50 (R. 86, Tr. 42) and which had a fair market value of $3,164,000. Thus, they had an equity of $2,372,361.50 in the said apartments. On that day they owned 55 per centum of Gyro's stock while one adopted child owned 10 per centum, one natural child owned 10 per centum, and Chris Mowry's 32 year-old brother owned 25 per centum. Thus, a finding that Chris and Natalie Mowry made a capital contribution to Gyro of that $2,372,361.50 necessarily comprehends a finding that Chris and Natalie Mowry intended to make a gift of 25 per centum thereof or $593,090.37 to Chris' adult brother, William. It also must comprehend a finding that Chris and Natalie Mowry intended to

make a gift of 20 per centum thereof, or $474,490.30, to two of their children. The reason of course is that their only claim against such "capital contribution" of $2,372,361.50 would be 55 per centum while William and their two children would be entitled to 45 per centum. Not only is it the uncontradicted testimony of Chris Mowry that he did not intend to make gifts totalling $1,067,580.67 to his adult brother and two of the children (Tr. 335-336, 331-333), but viewed from an objective sense there is no rationality to such a finding.

To begin with, William Mowry was a man of financial substance who owned ranches and business interests in Mexico. (Tr. 335). Next, what mother (Natalie Mowry) of one natural and one adopted child, who was then planning to and did adopt more children (Tr. 332), would intend a gift of $593,090.37 to her husband's financially able adult brother, William, especially when such a gift was not only at her own expense to the extent of one-half or $296,545.18 but also at the expense of the two children she then had and those which she intended to and did in fact adopt in the future. (Tr. 331-332). Also, in view of the then intention of Chris and Natalie Mowry to adopt more children and their policy of making equal gifts to each, the court's conclusion that they intended to make a capital contribution of their $2,372,361.50 equity in the apartments to Gyro is totally unreal because it forces them against their intention to make a gift of $474,490.30 to two children and leaves them with insufficient equity to make equal gifts to the children they adopted subsequently. (Tr. 442).

VIII

When The Commissioner Departs From The Grounds Relied On In His Notice Of Deficiency To Sustain A Theory Later Raised, He Has The Burden Of Proving Any New Matter Raised, And Hence, Where As Here, He Has Not Done So, The Taypayer Prevails.

The applicable rule of law, according to 10 Mertens, Law of Federal Income Taxation, § 58 A. 35, at page 98, is that:

> ". . . when the Commissioner departs from the grounds relied on in his statutory deficiency notice to sustain a theory later raised, he has the burden of proving any new matter raised."

Cases so holding are Massingale v. U. S., 59-1 U. S. T. C. Par. 9298 (D. C. Ariz. 1959) and Service Life Ins. Co. v. U. S., 189 F. Supp. 282 (D. C. Neb., 1960), aff'd. 8 Cir., 1961, 293 F. 2d 72.

In this case the notice of deficiency stated only that depreciation was disallowed in the respective amounts of $83,932.52 for 1959 and $100,775.97 for 1960. (R. 105-106). The Commissioner's agent who prepared the notice of deficiency conceded that the statutory notices do not mention the theory of law under Section 362 (a) (2). (Tr. 168-169). He further conceded that any written reference to the basis of the deficiency being a capital contribution under Section 362 (a) (2) was in his statement supporting the notice which is never shown or mailed to taypayers and was not presented to Gyro. (Tr. 211, 216).

Since the 30 Day letter issued to Gyro prior to the notice

of deficiency stated that all of the income and expenses from the said apartments was being assigned to Chris and Natalie Mowry and that Gyro did not own or possess the apartments (R. 98-99, Tr. 147-148), Gyro took the deposition of the author of the notice of deficiency to find out what was the basis thereof. At that deposition proceeding on October 15, 1965, said author was asked--and was instructed by the government counsel who tried this case to answer yes or no--the following question:

> "Q. As to those items on Exhibit A (attached to the Notice of Deficiency on which the old Mowry basis was used, Mr. Nisbet, when you said that the basis of the Mowrys was used, the item being the basis of the transferors, was the disallowance on the ground that the transfer into the corporation was a <u>nontaxable</u> <u>exchange</u>.
>
> * * *
>
> The Witness. Yes, <u>nontaxable</u> <u>exchange</u>" (R.134).

Because a nontaxable exchange between a transferor and a corporation is provided for in Section 351 and is a term of art well known among tax practicioners as describing Section 351, there is no doubt that the Commissioner's stated position to that point in time was that the basis to Gyro was determined under Section 362 (a) (1) as the basis of Chris and Natalie Mowry because it was acquired in connection with a transaction to which Section 351 applied rather than as a contribution to capital described in Section 362 (a) (2).

Thereafter, on May 11, 1966, the government filed Stipulation of Facts No. 1 providing in paragraph 10 that "Gyro

Engineering Corporation purchased from Chris and Natalie Mowry "the three apartment developments". (R. 46, 50).

Thus, the Commissioner departed from the grounds relied on in his statutory notice of deficiency: (1) because there were no grounds set forth therein and any theory adopted would be a departure; (2) because the 30 Day letter, admissable to explain the basis of a deficiency notice, adopted the theory that the income from the real property was not Gyro's; (3) because the author of the notice explained the theory as being based on there having been a nontaxable exchange rather than a contribution or donation to capital.

Having so departed from the grounds relied on in his notice of deficiency to sustain the theory later raised by him in the pretrial order filed June 20, 1966 that there was no purchase but a capital contribution to Gyro, the burden of proving there was no sale was on the Commissioner. For the reasons set forth in this brief, and particularly because the Commissioner stipulated there was a purchase, he has failed to carry that burden. The trial court erred in denying Gyro's pretrial motion for a ruling that such burden was placed on the Commissioner. (R. 133-139, 150, Tr. 39).

IX

The Government's Defense, Set Forth In The Pretrial Order Of June 20, 1966, That There Was No Sale But A Contribution To Gyro's Capital Was Barred By The Statute Of Limitations

The returns for 1959 and 1960 were filed by Gyro more than five years prior to the date of June 20, 1966 when the pretrial order was filed in which the government first claimed in writing that there was no sale to Gyro on January 1, 1959 but a contribution to capital. (R. 65, 70). The statute of limitations provided for in Section 6501 (a) has run on such defense. Hammond v. Maloney, 80 F. Supp. 212, 217 (D. C. Ore. 1948).

X

Many Of The Findings Of Fact Are Clearly Erroneous

A large number of the findings of fact submitted by the government and thereafter signed by the trial court are either without any support in the record or are flatly contradicted by the stipulations of fact and other evidence or are guilty of the sin of omission. The result is a false and grossly distorted statement of facts which is clearly erroneous as a whole and in its individual parts. For example:

Finding of Fact No. 8. (R. 709)

Here the statement or inference is made that there really was no capital paid into Gyro for the 10,000 shares of issued stock. This was accomplished by putting quotation marks around the words "paid-in" and by the content of the finding itself. Yet, in page 4 of Stipulation of Facts No. 2 at lines 9 through 15, material which was inserted in the stipulation at the government's request, it is set forth that Gyro had $10,000 of paid-in capital. (R. 84). Also, in page 3 of Stipulation of Facts No. 1 at lines 15 through 19 and in page 4 thereof at lines 9 through

12, it is stated that "Chris and Natalie Mowry paid $2,500 for the shares (2,500) issued April 20, 1953 and retained by Natalie Mowry," that "Twenty-five hundred dollars was also paid for the shares transferred from Chris Mowry to William Mowry," and that "William Mowry actually supplied the consideration of 25 per cent of the stock interest in Gyro Engineering Company" on April 20, 1953. (R. 48, 49).

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>10</u>. (R. 4).

It was stipulated that Gyro's purpose in acquiring the Paloma Street property was investment. (R. 84). Therefore, can such a fact lead to a conclusion that Gyro engaged in no activities from 1953 to January 1, 1959, particularly when, as will be shown below, the evidence is to the contrary.

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>12</u>. (R. 710).

This finding implies that Gyro never received the $30,896.65 condemnation award from the Paloma Street property, but the evidence is that the check for $30,896.65 was payable to Gyro, endorsed by Gyro to Chris and Natalie Mowry, and credited by them in payment of the $30,000.00 down payment required by the terms of the January 1, 1959 sale of their real property to Gyro. (Tr. 426). Also, the government stipulated in page 5 of Stipulation of Facts No. 1 at lines 25 through 27 that:

> "On March 30, 1959 Gyro Engineering Corporation paid $30,896.65, the proceeds of the condemnation award it received that date, to Chris Mowry." (R. 50).

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>13</u>. (R. 710)

Here the Sales and Purchase Agreement of January 1, 1959 is referred to as"purported" and is placed within quotation

marks ("sales and purchase agreement"), the sale price of $3,164,000 referred to as "purported" and is placed within quotation marks ("sale price"), and the promissory notes referred to as "promissory notes." However, there is no statement in Stipulation of Facts No. 1 that it is a "purported" Sales and Purchase Agreement or that the promissory notes were purported. (R. 50). Nor does the said stipulation refer to a "sale price." This finding contradicts Paragraphs 10, 11, 17, 23 and 27 of Stipulation of Facts No. 1. (R. 50, 51, 53, 54).

<u>Finding of Fact No. 16</u>. (R. 712)

This finding states that the tax advantages resulting from a stepped-up cost basis to Gyro were compounded because the capital gain reported by Chris and Natalie Mowry was not taxable due to offsetting losses from a farming venture. Such a statement is both wrong and ludicrous. The capital gain tax is a maximum of 25 per cent. Thus, in order to eliminate $15,000 of capital gain tax each year (1/4 of the $60,000 in annual payments on the purchase price), Chris and Natalie Mowry would have to sustain economic losses of at least $30,000 annually from the farming venture. There is no tax advantage in losing $30,000 in order to eliminate $15,000 of tax. Therefore, the tax advantages from the stepped-up basis were not compounded by the farming losses. No competent tax counsel advises a client to lose $30,000 in order to eliminate $15,000 of tax. No rational taxpayer loses $30,000 merely to keep the government from collecting $15,000.

<u>Finding of Fact No. 18</u>. (R. 713)

The finding states that the basis of the Commissioner's

notice of deficiency was "his determination that the transfer was not, for federal tax purposes, a bona fide sale," but a contribution to capital. As shown more fully in Point VIII, **this is** wrong. The Commissioner's agent who wrote the notice of deficiency testified that the notices of deficiency "do not mention the theory of law" under "Section 362 (a) (2) which is the whole basis of our disallowance" (Tr. 168-169), and that his written statement in support of the notice of deficiency in which the basis is set forth was not mailed to Gyro or to any taxpayer. (Tr. 216-217).

Finding of Fact No. 19. (R. 713)

The finding mistates appellant's contention that Commissioner v. Brown, supra, holds that a sale is a transfer of property for a fixed sum of money, and that here the government stipulated there was a transfer of property for a fixed sum of money.

Finding of Fact No. 20. (R. 713)

To find that outside of holding title to a piece of unimproved real property, Gyro had been substantially inactive as a corporation from 1953 to January 1, 1959 is unsupported. In Stipulation of Facts No. 2, at page 1, it is stated that Gyro "made Scorby test equipment and several test panels," and from "April 20, 1953 to 1955 checked into some parcels of real estate," and "purchased a parcel of land." (R. 80). Also, from the middle of April in 1953 until January 1, 1959, it worked on a number of different fields of scientific research including long range weather forecasting, how the eye sees color, and the unified field theory. (Tr. 239-240). Each investigation subsequently bore fruit, and Gyro has a patent pending covering three

dimensional color television, and makes accurate long range weather forecasts. (Tr. 239-240).

Finding of Fact No. 23. (R. 714)

It is wrong to state that Gyro had "little or no cash or working capital" on January 1, 1959 because prior thereto during 1958 it knew it was to receive approximately $30,000 in cash from the Paloma Street condemnation award. (Tr. 421-422, 423-424). The $30,000 cash down payment was paid by Gyro to Chris Mowry on March 30, 1959. (R. 50)

Finding of Fact No. 25. (R. 715)

The statement that Chris and Natalie Mowry "purported to sell property allegedly worth $3,164,000" and the reference to the "alleged down payment of $30,000" are clearly erroneous. The government stipulated that Gyro paid Chris Mowry $30,896.65 on March 30, 1955. (R. 50). The other statements are erroneous for the reasons set forth above regarding Finding of Fact 13, and because there is no finding that the fair market value of the property on January 1, 1959 was not $3,164,000.

Finding of Fact No. 28. (R. 716)

The finding that the notion of "payments" on money "notes" is"misleading" is clearly erroneous. Stipulation of Facts No. 2 at line 32 of page 8 and lines 1, 5 and 6 of page 9, states that:

> "Payments of principal were to be made at the rate of $60,000.00 per year. . . . The said $60,000.00 annual payments were made through 1963 or a total of $300,000.00." (R. 86-87).

Finding of Fact No. 29. (R. 718)

This finding to the effect that "the corporate identity of Gyro Engineering Corporation usually was ignored" is clearly erroneous in several of its specific parts and in its totality. Also, it is not relevant because it goes to support a conclusion disregarding the corporate entity and taxing the income from the apartments to Chris and Natalie Mowry (the approach taken in the 30 Day letter) whereas here the government has taxed the corporation.

The statements found at lines 8 through 12 of R. 718 are not based on evidence. The finding respecting leases subsequent to 1959 being in the name of Chris and Natalie Mowry is not complete since the old leases contained provisions automatically renewing the lease. (Tr. 515).

Finding of Fact No. 30. (R. 719)

The finding supports a conclusion that Gyro did not exist whereas the government stipulated that Gyro was not only an existent corporation during all years relevant here but was a "corporation recognizable for federal tax purposes." (Tr. 460-461).

Finding of Fact No. 31. (R. 720)

The finding that Gyro had no employees in any usual sense in the years in question is entirely misleading because the trial court allowed as deductions from gross income of Gyro $22,554.48 for maintenance and $21,003.08 for repairs during 1959 and $52,477.34 for repairs and maintenance for 1960. (R. 65,68; Exhibits 2 and 3 attached to Stipulations of Facts No. 1; Tr. 375, 382, 389-391, 522-523; Exhibits 5 and 8). In addition there

were managers for each of the three apartments who were treated by Gyro as self-employed. Thus, it is misleading in the extreme simply to say, without amplification, that Gyro had no employees.

Finding of Fact No. 32. (R. 720)

The reference to the bills and expenditures of Gyro as "purported" is clearly erroneous since the trial court allowed Gyro as deductions from its gross income $73,943.62 for repairs, maintenance, taxes, interest and losses for 1959, and $131,235.18 for maintenance, gardening, painting, repairs, taxes and interest for 1960. There is no evidence in the record to support the finding that personal expenses of the Mowrys were charged to Gyro, and if there had been such evidence, the trial court could not have allowed, as it did, the full deduction for $73,943.62 in 1959 and $131,235.18 for 1960. What the trial court did here was disallow only the bulk of the depreciation deductions claimed by Gyro in 1959 and 1960 on the ground that Gyro received the property as a capital contribution and must take the cost basis of Chris and Natalie Mowry. However, to justify that ruling, it questions the fact and propriety of nearly $200,000 worth of other deductions which in fact it allowed to Gyro.

Finding of Fact No. 33. (R. 720)

To find, on the one hand, that Gyro is entitled to nearly $200,000 of deductions for 1959 and 1960, while on the other hand, finding that "no adequate segregation of the Mowry's personal expenses from the claimed expenses of Gyro was made" is clearly erroneous. Obviously the trial court was satisfied that the proof of the nearly $200,000 in claimed expenses of Gyro,

offered in the form of thousands of checks and days of testimony, constituted an adequate segregation of any alleged Mowry personal expenses from Gyro's expenses.

Finding of Fact No. 34. (R. 721)

The finding is clearly erroneous since it supports only the conclusion that Gyro was in reality only Chris Mowry in disguise whereas the government stipulated that Gyro was recognized for federal tax purposes for all years relevant herein. (Tr. 460-461).

Finding of Fact No. 36. (R. 721)

The finding that Chris Mowry did not get the appraisals "in writing" which he testified were used in determining the sale price until after an Internal Revenue Service audit began in 1961 is grossly misleading and clearly erroneous. The only testimony on the point was from Chris Mowry who testified on cross examination that the sale price was determined in 1958 after consulting with several appraisers and real estate men in Pasadena among whom were one Bill Williamson, Jack Flynn, and a Mrs. Golet, an attorney, and that upon request of an Internal Revenue Agent in 1961, written appraisals were then obtained from Messrs. Williamson and Flynn, a long time before Mr. Nisbet wrote his secret report that it was the government's position that no sale had occurred. (Tr. 432-433). The statement that the deed recording the sale was not filed until March 17, 1961 whereas an Internal Revenue Service audit began in early 1961 is clearly erroneous because the first agent did not contact Gyro or Chris Mowry until May of 1961 (Tr. 345-346). The finding that Chris Mowry tried to "dress up" the transaction

considerably after the Internal Revenue Service audit began is therefore clearly erroneous, particularly since the Revenue Agent's 30 Day letter was not issued until November 30, 1962 and the Commissioner never revealed his "no sale" argument until years later.

Finding of Fact No. 37. (R. 722)

The finding that "no evidence was presented to show how Gyro treated the January 1, 1959 transaction" on"its books and financial statements" nor"books of account or financial statements of Gyro" presented to the court is clearly erroneous. The reasons are that the government stipulated over and over that there was a valid transfer to Gyro, that Gyro owned the real property, that Gyro was recognized for federal tax purposes, that payments of $300,000 were made on the purchase price, that Gyro purchased the apartments and that Gyro need not produce evidence to prove the stipulated facts.

Finding of Fact No. 39. (R. 722)

This finding, a summary of earlier findings, is clearly erroneous for the reasons set forth with respect to each finding upon which it is based. Furthermore, it is not a finding but is qualified by the word "apparently."

Finding of Fact No. 40. (R. 723)

Stating that the sale was purported and "in no sense a bargained or arm's length transaction" is clearly erroneous because it is based solely on the premise that Chris Mowry in effect dealt only with himself. This premise is based not on evidence or fact concerning the sale on January 1, 1959 but on the government's contention that Gyro was "wholly owned" by

Chris Mowry (Tr. 720), that "when a controlling stockholder deals with his corporation" there "is almost a presumption--an inference--that you don't have what is called an arm's length transaction" (Tr. 709). First, Gyro was not wholly owned by Chris and Natalie Mowry. They owned 55 per centum of its stock while their minor children owned 20 per centum and Chris' adult brother William owned 25 per centum. Second, if there is a presumption that a transfer between a controlling stockholder owning 55 per centum or 75 per centum of the stock cannot result in an arm's length transaction, thereby negating a sale according to the government's lights, why did Congress allow any stockholder owning 79 per centum to obtain long term capital gain on a sale of depreciable assets to his corporation? Section 1239. This finding is a legal conclusion and an erroneous legal conclusion.

<u>Finding of Fact No. 41</u>. (R. 723-724)

The finding is clearly erroneous because the tax consideration was only one of the aspects of the January 1, 1959 sale which Chris Mowry considered as the trial court itself stated. (Tr. 479). The other reasons were to get the apartments out of his individual name, to avoid problems at Chris Mowry's death since he had had a heart attack, to obtain the management of his brother who already owned 25 per cent of the stock, to avoid dissolution of the apartment house in case of Chris Mowry's death, to ease the program of making gifts to his children, and because Chris Mowry wished to exercise his right to enjoy the benefits of capital gain in selling his property. (Tr. 333-335).

Finding of Fact No. 42. (R. 724)

To find that "there is warrant for an inference that the transaction was principally tax motivated, and indeed that generation of a stepped up basis for depreciation and other tax savings devices was its raison d'etre" is not a finding. To say that there is warrant for an inference is not the equivalent of finding as fact that the transaction was principally tax motivated. However, assuming it is a finding, the material above on Finding of Fact No. 41 shows that such a finding would be clearly erroneous.

Finding of Fact No. 43. (R. 724)

The finding that the $3,164,000 of apartments "were essential for the conduct of corporate business" of Gyro in the sense that it was the only way it could go into "business" as a regular activity for profit is clearly erroneous. Gyro had, prior to the sale on January 1, 1959, $10,000 of paid in capital and knew during 1958 that it was going to receive approximately $30,000 from a condemnation award.

Also, it had engaged in business from 1952 to January 1, 1959 when it made Scorby test equipment and test panels (R. 80-81), attempted to obtain Army and Navy contracts (R. 80-81), investigated and purchased real estate (R. 80), did work on long range weather forecasting, and worked on how the eye sees color. (Tr. 239-240).

Finding of Fact No. 44. (R. 725)

This is not a finding of fact, and if so, it is clearly erroneous. All the trial court is doing is wondering about the practical effect of payments "on notes" which "*might* have been

made or <u>not</u> made." The government stipulated in Stipulation of Facts No. 2 at paragraph 16, and the trial court adopted it as fact, that:

> "Payments on the principal were to be made at the rate of $60,000.00 per year. . . . The said annual payments were made through 1963 or a total of $300,000.00." (R. 86-87).

<u>Finding of Fact No. 45</u>. (R. 725)

The finding that Chris Mowry testified "with reservations" that he would subordinate his indebtedness if additional financing were to be obtained by Gyro is clearly erroneous and is illustrative of the numerous gross errors involved herein. Chris Mowry first testified that there was about $2,000,000 still due him and Natalie Mowry on the $3,164,000 sale price (Tr. 344), that he had recently obtained mortgage loan commitments on the three apartments of $1,800,000 (Tr. 337-388), and then the trial court asked if in his negotiations on such loan commitments he and Natalie Mowry would have to subordinate their indebtedness and whether that was agreeable to Chris and Natalie Mowry (Tr. 345); the full answer was:

> "Provided that we got paid the proceeds of the loan. <u>Otherwise</u>, no." (Tr. 345).

In short, the phrase "with reservations" in this finding means that Chris Mowry testified he would subordinate the $2,000,000 indebtedness owed to him and Natalie Mowry <u>only</u> if the $1,800,000 loan proceeds were paid to them on the $2,000,000.

Since the bulk of businessmen represented by most lawyers would discount a $2,000,000 long term debt for $1,800,000 today,

it is obvious that subordinating to the extent of $200,000 in order to get $1,800,000 in cash is not subordination at all.

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>46</u>. (R. 725)

It is clearly erroneous to find that Gyro's paid in capital and capital surplus on January 1, 1959 was $10,000 and then conclude that the debt to equity ratio is 316.4 to 1 in view of indebtedness represented by the purchase price of the apartment. Since Gyro knew in 1958 it was going to receive the approximately $30,000.00 condemnation award, the gain therefrom or $23,096.65 was a receivable which increased Gyro's capital and capital surplus to $33,096.65 on January 1, 1959. The debt to equity ratio is therefore $3,164,000 to $33,096.65 or 90 to 1.

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>47</u>. (R. 726)

That this finding is clearly erroneous has been shown at page 40, supra; there is no finding of fact and no substantial evidence to support it if it is.

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>48</u>. (R. 726)

It is clearly erroneous to find that there was "little or no business purpose for the transaction" in view of the evidence set forth above under Finding of Fact No. 41.

<u>Finding</u> <u>of</u> <u>Fact</u> <u>No</u>. <u>49</u>. (R. 726)

The finding states that the "character" of the transaction "seems unrealistic and uneconomic" because it appears highly dubious that <u>hypothetical</u> typical average investors "would have entered into the transaction had it been negotiated at arm's length between unrelated parties." This is not only clearly erroneous, but it is fantastic in view of the testimony by the government's "expert" that he would buy the real property for

$3,164,000 on the terms of this sale (Tr. 601-602), and his agreement with the trial court's statement that this type of transaction actually benefits the seller financially (Tr. 605-606). It was after that point that the trial court rejected the summary of the government "expert's" testimony (Tr. 609). In short, the government prepared for signature and the trial court signed a finding of fact which is actually contradicted by the government's "expert" and the trial court itself. It is also clearly erroneous to find that no credible evidence was introduced by Gyro that "outside investors" would have entered into this transaction in view of the Marshall & Stevens testimony that the value was $2,985,000 on a cash sale and the above statements by the government's "expert" on sham transactions.

Finding of Fact No. 50. (R. 726)

The finding that Chris Mowry's testimony concerning his reasons for selling the properties is "somewhat" unconvincing in light of the fact he continued to perform the same management duties as before is clearly erroneous. Of the five reasons set forth above under Finding of Fact No. 41, only one referred to management problems, and therefore rejection of his testimony on the ground that he continued to manage the apartments is erroneous. Furthermore, a finding that his testimony is "somewhat unconvincing" is not a finding that his testimony as to the other reasons is unbelievable or false.

Finding of Fact No. 51. (R. 727)

Finding that the proceeds of the $30,896.65 condemnation award "presumably" remained available to Gyro is clearly erroneous because it contradicts Stipulation of Facts No. 1 which

states at paragraph 12:

> "On March 30, 1959 Gyro Engineering Corporation paid $30,896.65, the proceeds of the condemnation award it received that date, to Chris Mowry." (R. 50)

Finding of Fact No. 52. (R. 727)

The finding that "there is little reason to suppose" that the $30,896.65 condemnation award proceeds were not used by Gyro to pay its bills is not a finding of fact, and if so is clearly erroneous for the reason set forth above under Finding of Fact No. 51.

Finding of Fact No. 53. (R. 727)

The finding that the parties did not stipulate that Gyro purchased the apartments is clearly erroneous for the reasons set forth in Point II, supra.

Finding of Fact No. 54. (R. 727)

The finding that the government has, since this case was in its administrative stages, taken the position that the transfer was not a sale is clearly erroneous for the reasons set forth in Point VIII, supra.

XI

The Trial Court Misinterpreted And Misapplied The Law Even Assuming Commissioner v. Brown, Supra, Were Not Applicable

Aside from the fact that the trial court's conclusions of law are based on findings of fact which are clearly erroneous, the conclusions are also fatally flawed because of the method by which they were constructed.

Instead of posing the precise question--was there a sale or a contribution to capital--and then turning to those cases which had set down the criteria to be used to answer that question, the conclusions submitted by the government adopt the familiar technique of finding several cases which deal with one-half of the above question or an entirely different question, extracting one or two of the several criteria applied therein and using it to construct a list of criteria which hopefully fit the facts of this case. Thus, one can prove that black is white, democracy is communism, and men are women.

For example, although the dicta in O. H. Kruse Grain & Milling Co. v. Commissioner, 9 Cir. 1960, 279 F. 2d 123, lists only eleven criteria to be applied in determining whether amounts transferred to a corporation are the result of a sale or a capital investment (not the same as a contribution to capital) (R. 734 - 735), the trial court's conclusions set forth sixteen criteria to be applied to the question herein of whether there is a sale or a contribution to capital. (R. 740-726). Similarly, in Kolkey v. Commissioner, 27 T. C. 37 (1956), which Commissioner v. Brown, supra, noted at footnote 7 was a case where the "sale" price was grossly excessive, the criteria set forth to determine whether there was a sale or capital investment (not a contribution to capital) only totaled eight. (R. 732 - 733). And in J. S. Biritz Construction Co., Par. 66, 227 P-H T. C. Memo Dec. (1966), a sole stockholder case which Conclusion of Law XVII states is "interesting for its recitation of the proper factors of decision" (R. 738), the criteria to be applied to determine whether there was a sale or capital investment (not a

contribution to capital) are eleven.

Nowhere in the Conclusions of Law is there set forth a case or several cases which announce the factors which determine whether there is a sale or a contribution to capital which are then applied to the facts of this case. The vice of failing to do so is best illustrated by comparing the criteria set forth by Judge Barnes in the Kruse case, supra, with the sixteen criteria actually applied by the trial court here in Conclusions of Law XXI through XXXVIII (R. 740 - 746). In doing so the Court will observe that only two of the criteria set forth by Judge Barnes (Nos. 3 and 8 found at R. 734) have been applied. Why? The answer is obvious. It is because the application of the other criteria here such as Nos. 1, 2, 4, 7, and 11 (R. 734), for example, are favorable to appellant. Similarly, only two of the criteria set forth in Kolkey, supra, (Nos. 1 and 5) are applied (R. 740 - 746) whereas several favorable to appellant are not applied, i. e. (8) was the price disproportionate to the fair market value, (7) was any control reserved as an integral part of the plan under the notes, (5) were payments of principal subordinated to dividends and other creditors, and (2) what was the business purpose in organizing the corporation. (R. 733). Likewise, only five of the eleven criteria set forth in Biritz, supra, (Nos. 1, 3, 6, 7 and 11) were applied, of which 1, and 3 are incorrectly applied. (R. 738, 740 - 746).

Furthermore, it is significant that of the sixteen criteria actually applied by the trial court only six were extracted from the above cases which allegedly set forth the proper criteria. The other ten just dropped out of the blue, so to speak, as each

was applied. Thus, absence of interest (R. 740, XXI), inordinately postponed due date (R. 740, XXII), assets revived corporation (R. 741, XXIII), assets essential to corporation (R. 741, XXIV), lack of formal security (R. 742, XXVII), absence of a sinking fund (R. 742, XXVIII), disproportionate debt-equity ratio (R. 743, XXIX), confusion of transferor's activities with corporation's activities (R. 744, XXXII), attempt to "dress up the transaction" (R. 744, XXXIII), no business purpose (R. 744, XXXIV), tax avoidance motive (R. 745, XXXV), lack of "substantial economic reality" (R. 745, XXXVI), and not arm's length (R. 746, XXXVIII) are all thrown in the hopper, some with a case citation and some without.

In short, what the government has done is take 6 of the 11 tests to determine if silver exists, 10 of the 40 or more tests to determine if helium gas is present, and then applied all 16 to a substance and determined that it is gold.

The hard fact is that the conclusions of law do not contain a single case or series of cases setting forth the criteria to be applied in determining under Section 362 (a) (2) or any other section whether a transfer to a corporation is a sale or a <u>contribution</u> to capital. And if any did so qualify, those criteria were not in fact applied here. Such failure is particularly illuminating when it is recalled that the leading text in federal income taxation sets forth the applicable cases in discussion of Section 362 (a) (2) and a footnote at 3A Mertens, Law of Federal Income Taxation § 21.127, footnote 16 stating:

> "It may be necessary to ascertain whether the property was sold to the corporation or contributed to its

capital. See Herff v. Dittmar Land Co. 32 BTA 349; Hollywood, Inc., 10 T. C. 175 (1949); Curran v. Comm., 49 F. (2d) 129 (CCA 8th, 1931); Sun Properties, Inc. v. U. S., 220 F. 2d 171 (CA 5th, 1955); Las Vegas Land & Water Co., 26 T.C. 881 (1956)."

However, not one of these cases ruled that there was a capital contribution, and the criteria applied therein show that appellant would prevail here if they were applied. Sun Properties, Inc. v. U. S. 5 Cir., 1955, 220 F. 2d 171, rejects most of the arguments made by the government here including the arm's length contention. See 220 F. 2d 171, 174 - 175, where the Fifth Circuit expressly held it would be "judicial legislation of the most inexcusable kind for a court" to disregard a transaction simply because it was not at arm's length, held there is no requirement that a transaction must be done in the customary manner, denied that a court made requirement of a business purpose independent from taking a gain is required to qualify a transaction as a sale, refused to hold that a 'thin' corporation is a ground to infer there was a contribution to capital, and finally, citing Gregory v. Helvering, 293 U. S. 465, as authority, pointed out that "a tax avoidance motive must not be considered as evidence that a transaction is something different from what it purports to be."

In addition to the above cases, the Pocket Supplement cited Murphy Logging Co. v. United States, 239 F. Supp. 794, as contra, but it was reversed in this Court at 378 F. 2d 222.

Applying erroneous tests was not the worst done in the conclusions of law. Even those tests were faultily applied. For

example, there was no subordination in fact here. After $300,000 of principal payments were made through 1963, Gyro had to pay $103,277.98 of taxes and interest herein, and was, as was stipulated, unable to make the payment for 1964 and 1965. (R. 87). The government, which has taken the cash proceeds after expenses and has asserted deficiencies against Chris and Natalie Mowry on the ground that the annual payments are dividends since the apartments constituted a contribution to capital, now says that since it has been paid there has in fact been a subordination. Also, there is no lack of security as the sale agreement demonstrates. Further, there was no absence of operating capital. Nor did they "dress up" the transaction. Also there were several business purposes. And to say the sale was not at arm's length when the property was sold for its fair market value is wholly erroneous.

Illustrative of the abject poverty of the government's case is its citation of Thielens v. United States (N. D. Ala. Sept. 21, 1965) (R. 739). There Mr. Thielens agreed with the government that there had not been a sale but a contribution to capital (R. 357 - 358), and that the price paid by the corporation greatly exceeded the fair market value. (R. 360). Is it any wonder the trial court held there was no question of fact for the jury, granted a directed verdict, and held there was a sale?

XII

The Case Cited By The Government To Support Its Interpretation Of Section 362 (a) (2), Murphy Logging Co. v. United States, 239 F. Supp. 794 (D. Ore.

1965), Was Later Reversed Here At 378 F. 2d 222.

In the opening brief filed below, the plaintiff pointed out that although the government specifically relied on Section 362 (a) (2), none of the cases gathered together by Mertens on the problem of determining whether there was a sale or contribution of capital under Section 362 (a) (2) had ruled in favor of the government. (R. 322 - 323). The government's brief replied by citing *Murphy Logging Co.* v. *United States*, 239 F. Supp. 794 (D. Ore. 1965) as one of the cases cited by Mertens on the point in the pocket supplement. (R. 504-505). However, subsequent to the trial court's ruling on March 22, 1967, *Murphy Logging Co.* v. *United States*, supra, was reversed by this Court on May 15, 1967 in 378 F. 2d 222. (R. 680 - 685).

XIII

Since Gyro Did Purchase The Apartments, It Is Entitled To Non-Recognition Of Gain Under Section 1033 With Respect To The Paloma Street Condemnation Award

There was a sale and purchase by Gyro of the apartments on January 1, 1959. Therefore, it did purchase property within the meaning of Section 1033.

CONCLUSION

The Commissioner's approaches herein are a form of legalistic schizophrenia. First, he disregarded the corporation and assigned the income to Chris and Natalie Mowry, later issued a

notice of deficiency which disallowed Gyro's purchase price cost basis but took no position, next said the sale was a nontaxable exchange, later actually signed a stipulation stating that Gyro purchased the apartment buildings, later claimed there was no sale but a capital contribution, later in the oral argument stated that the only issue here is whether Gyro is entitled to a refund and not whether there was a sale (Tr. 713 - 714), and finally in his brief, told the trial court that it need not make any conclusions on the above points but should "simply hold that taxpayer has not carried its burden of proof." (R. 537).

In short the government had no position on the law except in the sense that it adopted a new and often contradictory position every few months. Its real position is set forth at page 1 of its post trial brief in the trial court:

> "Stripped to 'bare bones," defendant's principal contention upon both major issues is that the purported sale of the apartment properties to Gyro was a sham transaction without substance or business purpose excepting tax avoidance." (R. 494).

That is, the government equates tax avoidance with sham transaction, and thereby hopes to negate the Supreme Court's ruling that a tax avoidance motive must not be considered as evidence that a transaction is something different from what it purports to be, Gregory v. Helvering, supra, and also to negate the decision of Congress in 1951 that the stepped up basis would not be denied in dealing with the problem of sales of depreciable assets to controlled corporations but capital gain would be denied in certain cases.

The word "sham" is the new magic word which is replacing the older slogan of "substance over form". No criteria are announced or applied. The technique is simply to utter the word whenever a larger tax can be collected.

The trial court should be reversed.

Respectfully submitted,

MC LANE & MC LANE

William Lee McLane
By William Lee McLane

Nola McLane
Nola McLane

Certificate

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United State Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

William Lee McLane
Dated: April 13, 1968 William Lee McLane

APPENDIX A

EXHIBITS

NUMBER	IDENTIFIED*	OFFERED*	RECEIVED*	REJECTED*
Exhibits to Stipulation of Facts No. 1:				
1 through 8	40	40	41	
Exhibits to Stipulation of Facts No. 2:				
9 through 12	40	40	41	
Plaintiff's Exhibits:				
1	92	93	93	
2	133	362	362	
3	163			
4	206	374	374	
5	206	382	382	
6	206	386	386	
7	206	388	388	
8	206	391	391	
9	245	460	460	
10	351	460	460	
11	391	407	409	
12	393	393	394	
Defendant's Exhibits:				
A through D	447	447	448	
E	610	609		609

*Page references are to Transcript.